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'Inherited' Nexus And Other Extreme Nexus Theories

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Nexus — whether a corporation has a sufficient connection such that it may be taxed by a state — is one of the most important issues in state tax. Various legal theories have been asserted (and are being asserted) to justify a state's imposition of a tax obligation on a corporation. While some courts have accepted such theories, several courts have pushed back against states' assertions of jurisdiction, including on due process grounds.

One theory — that a corporation has nexus with a state because it is part of the unitary business of an in-state taxpayer — is the primary theory discussed in this article. The Maryland Court of Special Appeals, in *Comptroller of the Treasury v. Gore Enterprise Holdings, Inc.,* recently articulated that theory, stating that if "a parent company undoubtedly has a requisite nexus, the only question is whether the subsidiary partakes in the parent's unitary business; if so, it inherits the parent's nexus. . . ."[1]

The U.S. Supreme Court established a test with four distinct prongs to determine the constitutionality of a state tax under the U.S. Constitution's commerce clause.[2] Two of those prongs are substantial nexus and fair apportionment.[3] The Supreme Court developed the unitary business principle as the "linchpin of apportionability," not as a test for substantial nexus.[4]

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In reaching its nexus holding, the *Gore* court misapplied Supreme Court precedent addressing the unitary business principle, including the Supreme Court's decision in *MeadWestvaco Corp. v. Illinois Department of Revenue*.[5] In this article, we analyze the *Gore* court's statement under Supreme Court precedent.[6] Also, we highlight some of the other nexus theories that have recently been asserted.

Gore

W. L. Gore & Associates Inc. (Gore) was a Delaware manufacturer that made local product sales in Maryland and had manufacturing facilities and more than 2,000 employees located in the state. Gore licensed intangibles from, and paid royalties to, Gore Enterprise Holdings Inc. (Holdings), and paid interest on loans to Future Value Inc. (Future Value). Holdings and Future Value, both subsidiaries of Gore, had no property or employees in Maryland and neither entity filed Maryland corporate tax returns. The Comptroller of Maryland assessed Holdings and Future Value on the theory that the entities had nexus with Maryland.

The court of special appeals upheld the state's assessment. In footnote 11, the court stated that the

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[1]*Comptroller of the Treasury v. Gore Enter. Holdings*, 60 A.3d 107, 115 n.11. (Md. Ct. Spec. App. 2013), *cert. granted*, No. 36 (Md. May 17, 2013).

[2]*See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[3]*Id.*

[4]*Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 439 (1980).

[5]*MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008). Morrison & Foerster LLP represented the taxpayer in *MeadWestvaco*.

[6]This article does not address other aspects of *Gore*.

distinction between "constitutional nexus" and the unitary business principle "is relevant where there is some question as to whether *any* part of a unitary business has a sufficient nexus with the taxing state."[7] Relying on *MeadWestvaco*, the court continued, "[b]ut where, as here, a parent company undoubtedly has a requisite nexus, the only question is whether the subsidiary partakes in the parent's unitary business; if so, it inherits the parent's nexus, and the tests are effectively merged."[8] The court determined that Holdings and Future Value had a sufficient nexus with Maryland because they were part of Gore's unitary business.

Analysis — *Gore*, Substantial Nexus, and the Unitary Business Principle

The *Gore* court's statement regarding the unitary business principle and nexus is unsupported by Supreme Court precedent. *Complete Auto* summarized the analytical framework for evaluating the constitutionality of a state tax under the commerce clause and clearly identified substantial nexus and fair apportionment as separate prongs of a four-part test.[9]

The separateness of the two prongs is further demonstrated in *Allied-Signal, Inc. v. Director, Division of Taxation.*[10] Under *Allied-Signal*, the constitutional nexus inquiry asks "whether the State has the authority to tax the corporation at all."[11] The focus of the nexus inquiry is on whether a corporation's connection to a state justifies imposition of a tax on the "actor."[12] Even if a sufficient nexus exists, *Allied-Signal* explained that there must also be a connection between a state and the activities of the corporation that the state seeks to tax.[13] This portion of the *Allied-Signal* Court's analysis clearly focuses on the fair apportionment prong of the *Complete Auto* test, and uses the unitary business principle to determine if such a connection exists.[14]

Substantial Nexus

In addressing substantial nexus, no Supreme Court decision has evaluated whether a corporation had nexus because it conducted a unitary business with an in-state taxpayer. Rather, the Supreme Court's decisions have always examined whether a specific corporation's contacts with a state justify the imposition of a tax. Usually, those examinations have focused on activities conducted by the corporation itself, such as having an office in a state, making deliveries in its own vehicles into a state, or having employees located in a state.[15]

In limited circumstances, the Supreme Court has recognized an "extension" of the substantial nexus principle and has found substantial nexus when a corporation is not itself conducting activities in a state but instead has third parties performing some activities on its behalf.[16] For example, in *Tyler Pipe*, the Supreme Court allowed Washington to impose a tax on a corporation with no physical presence in Washington based on an independent contractor's solicitation activities in the state.[17] Although the Supreme Court evaluated whether the corporation's own connection to the state established nexus, it attributed the third parties' active solicitation activities to the corporation because they were associated with the corporation's "ability to establish and maintain a market" in the state.[18] That finding of substantial nexus, based merely on third-party solicitation activities in a state, is the "furthest extension" of a state's ability to tax an out-of-state corporation that the Supreme Court has addressed.[19]

Based on the foregoing, *Gore* is incorrect to the extent that it attributes Gore's activities to Holdings and Future Value for nexus purposes without applying the *Tyler Pipe* framework, under which Holdings and Future Value would presumably not have nexus with Maryland.

Unitary Business Principle

Once the substantial nexus requirement has been satisfied, the inquiry then "shifts from whether the State may tax to what it may tax," that is, whether

[7] *Gore*, 60 A.3d at 115 n.11 (emphasis in original).

[8] *Id.*

[9] *Complete Auto*, 430 U.S. at 279. Later Supreme Court jurisprudence modified the applicability of the fair apportionment requirement to sales and use taxes. *See Oklahoma Tax Comm'n v. Jefferson Lines Inc.*, 514 U.S. 175 (1995).

[10] *Allied-Signal Inc. v Director, Division of Taxation,* 504 U.S. 768 (1992).

[11] *Allied-Signal*, 504 U.S., at 778. The Supreme Court has also stated that a state must have a nexus with the transaction the state seeks to tax. *Goldberg v. Sweet*, 488 U.S. 252, 263 (1989). We do not address that aspect of substantial nexus, but note that the unitary business principle is not a test for determining whether that nexus exists.

[12] *Allied-Signal*, 504 U.S. at 778.

[13] *Id.*

[14] In our view, the *Allied-Signal* Court's use of the word "activity" in its apportionment analysis should not be read to implicate an analysis of substantial nexus, even though *Complete Auto* and *Goldberg* use the word "activity" to discuss substantial nexus.

(Footnote continued in next column.)

[15] *See, e.g.*, *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975); *Miller Bros. v. Maryland*, 347 U.S. 340 (1954).

[16] *See Tyler Pipe Indus. v. Wash. Dep't of Revenue*, 483 U.S. 232 (1987); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

[17] *Tyler Pipe*, 483 U.S. at 250.

[18] *Id.*

[19] *See Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (discussing *Scripto*, which, like *Tyler Pipe*, involved third-party solicitation).

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a connection to the activity at issue exists.[20] In addressing the second inquiry, the *Allied-Signal* Court explained that:

> [I]n the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax. . . . The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation at all [that is, nexus]. The present inquiry, by contrast [to nexus], focuses on the guidelines necessary to circumscribe the reach of the State's legitimate power to tax. We are guided by the basic principle that the State's power to tax an individual's or corporation's activities is justified by the protection, opportunities and benefits the State confers on those activities.[21]

To answer the question of what activity a state may tax, the Supreme Court developed the fair apportionment concept and reiterated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle."[22] The unitary business principle prevents income derived from business activity that is unrelated to a state from being included in the state's apportionable tax base.[23] The Supreme Court developed the unitary business principle in several cases, and most recently explained in *MeadWestvaco* that when income arises from an entity's unitary business or from a unitary asset, such income may be subject to apportionment.[24]

The *Gore* court quoted *MeadWestvaco* as support for its nexus theory, and added the word "parent" in its citation as follows:

> Where, as here, there is no dispute that the [parent] taxpayer has done some business in the taxing State, the inquiry shifts from whether the State may tax to what it may tax. . . . To answer that question, we have developed the unitary business principle.[25]

The *Gore* court misapplied *MeadWestvaco* in at least two ways. First, the inclusion of "[parent]" in the above citation is improper because *MeadWestvaco* did not involve a parent-subsidiary relationship.[26] Second, substantial nexus was not at issue in *MeadWestvaco*.[27] Rather, the issue in the case was whether Illinois could tax the income from Mead Corp.'s (the taxpayer's) sale of its Lexis/Nexis division.[28] The actual language in *MeadWestvaco* merely recognizes that because Illinois could tax the actor (that is, Mead Corp.), the Supreme Court's challenge was to examine whether a connection to the activity (that is, the sale of Lexis/Nexis) was present so that the income at issue could be taxed by Illinois as apportionable income.

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Gore is just one example of the misconception in state taxation that the unitary business principle is a proxy for determining substantial nexus. Another recent example includes a Wisconsin regulation providing that "[f]or a combined group, nexus is determined for the unitary business as a whole. . . . Therefore, if a member of a combined group has nexus in Wisconsin and that nexus is attributable to the combined group's unitary business, all members of the combined group have nexus in Wisconsin."[29] It should be noted, however, that that approach is inconsistent with that of other states. In California, for example, a corporation is not subject to the minimum corporation franchise tax if it does not have nexus with the state — even if the corporation is included in a unitary combined return.[30]

Other Extreme Nexus Theories

Some state taxing authorities have asserted other nexus theories, and some state legislatures have passed legislation that is inconsistent with Supreme Court nexus precedent. Those assertions often incorrectly attribute the actions of third parties or affiliates to a corporation. Fortunately, some courts have flatly rejected those efforts, in some cases on due process grounds.[31] In other states, those assertions remain open to challenge.

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[20] *MeadWestvaco*, 553 U.S. at 25.

[21] *Allied-Signal*, 504 U.S. at 778 (internal quotations and citations omitted).

[22] *Mobil Oil*, 445 U.S. at 439.

[23] *See Allied-Signal*, 504 U.S. at 780.

[24] *See, e.g., MeadWestvaco*, 553 U.S. at 29-30; *Allied-Signal*, 504 U.S. at 778-88; *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 162-71 (1983); *Mobil Oil*, 445 U.S. at 438-442.

[25] *Gore*, 60 A.3d at 115 n.11 (quoting *MeadWestvaco*, 553 U.S. at 25).

[26] *MeadWestvaco*, 553 U.S. at 22. Although at some times Lexis/Nexis was operated as a division and at other times it operated as a separate entity, at the time of its sale Lexis/Nexis was a division. *Id.*

[27] *Id.* at 25.

[28] *Id.* at 19.

[29] Wis. Admin. Code Tax section 2.82(5)(a).

[30] Calif. Revenue and Taxation Code section 23153; California Forms & Instructions 100, 2012 Corporation Tax Booklet, pp. 6-7, 10 (Calif. Franchise Tax Bd.).

[31] For a further analysis of nexus under the due process clause, see Paul H. Frankel, Craig B. Fields, and Richard C. Call, "The Due Process Clause as a Bar to State Tax Nexus," *State Tax Notes*, Oct. 29, 2012, p. 343.

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In March 2013, the Tennessee Supreme Court held that due process prohibited Tennessee from requiring a foreign cigarette manufacturer to make payments into the Tobacco Manufacturers' Escrow Fund, even though more than 11.5 million cigarettes manufactured by the manufacturer were sold in Tennessee.[32] An independent wholesaler acquired the cigarettes from the manufacturer and sold them to another third party that arranged for sales of the cigarettes in Tennessee. The court found the manufacturer could not be liable (that is, subject to the charge) merely as a result of "placing its . . . cigarettes in the international stream of commerce."[33] The court also noted that the unilateral acts of third parties resulted in the cigarettes being sold in Tennessee and expressed its unwillingness to "conflate three legally and managerially independent companies . . . in order to exert jurisdiction over a manufacturer that remained mostly aloof from the international marketing and distribution of its cigarettes."[34]

In December 2012 a federal bankruptcy court rejected the Oregon Department of Revenue's assertions that a parent corporation was liable for the unpaid taxes of its subsidiaries because the court found that the corporation did not have nexus for due process or commerce clause purposes.[35] Among the theories asserted by the Oregon DOR was that "by filing the return in its name, [the parent] admitted that it was doing business in Oregon," inasmuch as Oregon law requires a corporation subject to tax in the state to file the Oregon consolidated return in its name.[36] Also, the Oregon DOR argued that the parent was doing business in Oregon merely because it owned entities that did business in Oregon.[37]

Another nexus theory can be found in Oklahoma's sales tax statutes. The statutes presume that a retailer engaged in business in Oklahoma, that is, a person required to collect tax, includes any corporation "that is part of a controlled group of corporations [as defined for federal tax purposes], and that controlled group of corporations has a component member that is a retailer engaged in business in this state."[38] We would not be surprised to see that presumption challenged in the future.

Going Forward

Gore's use of the unitary business principle as a test for substantial nexus is not grounded in Supreme Court precedent, and it is just one of many nexus theories that are asserted today. Fortunately, some courts have flatly rejected states' assertions of nexus based on such theories, while other theories remain subject to challenge. ✰

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[32]*State v. NV Sumatra Tobacco Trading Co.*, No. M2010-01955-SC-R11-CV (Tenn. Mar. 28, 2013).
[33]*Id.* at 47.
[34]*Id.* at 45.
[35]*In re Washington Mutual, Inc.*, 485 B.R. 510 (Bankr. D. Del. 2012).
[36]*Id.* at 514.
[37]*Id.* at 516.
[38]*See* Okla. Stat. tit. 68, section 1401(9)(d).

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